

Report  
of the  
Examination of  
Ambac Assurance Corporation  
New York, NY  
As of December 31, 2001

## TABLE OF CONTENTS

	Page
I. INTRODUCTION.....	2
II. HISTORY AND PLAN OF OPERATION .....	4
III. MANAGEMENT AND CONTROL .....	11
IV. AFFILIATED COMPANIES .....	13
V. REINSURANCE .....	22
VI. FINANCIAL DATA .....	24
VII. SUMMARY OF EXAMINATION RESULTS .....	33
VIII. CONCLUSION.....	36
IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS.....	37
X. ACKNOWLEDGMENT .....	38



# State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

**Scott McCallum**, Governor  
**Connie L. O'Connell**, Commissioner

**Wisconsin.gov**

August 23, 2002

121 East Wilson Street • P.O. Box 7873  
Madison, Wisconsin 53707-7873  
Phone: (608) 266-3585 • Fax: (608) 266-9935  
E-Mail: [information@oci.state.wi.us](mailto:information@oci.state.wi.us)  
Web Address: [oci.wi.gov](http://oci.wi.gov)

Honorable Alfred W. Gross  
Chairman, Financial Condition (E)  
Committee, NAIC  
Secretary, Southeastern Zone, NAIC  
Commissioner of Insurance  
Commonwealth of Virginia  
Tyler Building  
Post Office Box 1157  
Richmond, Virginia 23218

Honorable Susan F. Cogswell  
Secretary, Northeastern Zone, NAIC  
Commissioner of Insurance  
State of Connecticut  
153 Market Street 7th Floor  
Hartford, Connecticut 06103

Honorable Darla L. Lyon  
Secretary, Midwestern Zone, NAIC  
Director, Division of Insurance  
State of South Dakota  
118 West Capitol  
Pierre, South Dakota 57501

Honorable Merwin U. Stewart  
Secretary, Western Zone, NAIC  
Commissioner of Insurance  
State of Utah  
State Office Bldg. Rm. 3110  
Salt Lake City, Utah 84114-6901

Honorable Connie L. O'Connell  
Commissioner of Insurance  
State of Wisconsin  
121 East Wilson Street  
Madison, WI 53702

Commissioners:

In accordance with your instructions, a compliance examination has been made of  
the affairs and financial condition of:

AMBAC ASSURANCE CORPORATION  
New York, NY

and this report is respectfully submitted.

## I. INTRODUCTION

The previous examination of Ambac Assurance Corporation ("Ambac Assurance," or the "company") was conducted in 1997 as of December 31, 1996. The current examination covered the intervening period ending December 31, 2001, and included a review of such 2002 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

- History
- Management and Control
- Corporate Records
- Conflict of Interest
- Fidelity Bonds and Other Insurance
- Territory and Plan of Operations
- Affiliated Companies
- Growth of Company
- Reinsurance
- Financial Statements
- Accounts and Records
- Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comment on the remaining areas of the company's operations is contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins. 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain

documentation with respect to the alternative or additional examination steps performed during the course of the examination.

## **II. HISTORY AND PLAN OF OPERATION**

Ambac Assurance Corporation is a Wisconsin domiciled insurer authorized to transact surety and financial guaranty insurance. The company operates as a financial guaranty insurer, and its principal business is the guaranty of timely payment of principal and periodic interest when due on investment grade credit obligations.

The company's present corporate organization was created from a corporate restructuring executed on June 18, 1985 under the supervision of the Wisconsin Commissioner of Insurance (the "Commissioner"). Under the 1985 restructuring, the business of the company's predecessor legal entity, American Municipal Bond Assurance Corporation (AMBAC), was transferred to a successor legal entity, AMBAC Indemnity Corporation ("New AMBAC"), which was subsequently renamed Ambac Assurance Corporation.

AMBAC was incorporated in Wisconsin in 1970, and was originally established as a subsidiary of the former MGIC Investment Corporation ("Old MGIC," the pre-1985 MGIC Investment Corporation). AMBAC was the nation's first financial guaranty insurer of municipal bond securities. In 1981 the underwriting operations of AMBAC were moved to New York City from Milwaukee, Wisconsin. Ownership of Old MGIC and its subsidiaries including AMBAC was purchased by the holding company Baldwin-United Corporation (Baldwin) in 1982. The Baldwin enterprise became financially impaired in 1983 due in part to excess corporate debt, and Baldwin filed petition for voluntary reorganization under Chapter 11 of the Federal Bankruptcy Code.

In 1984 the Commissioner approved a Plan of Acquisition (the "Plan") whereby the ongoing successful business enterprise of AMBAC could be protected from the bankruptcy of Baldwin and be continued in a successor legal entity. Pursuant to the Plan, the holding company AMBAC Inc. was formed in 1984 to facilitate the transfer of the municipal bond insurance business of AMBAC. AMBAC Inc. purchased the then existing insurer Verex Indemnity Corporation, which was incorporated in Wisconsin on February 25, 1970 under the name CMI Credit Insurance, Inc. and renamed Verex Indemnity Corporation on January 25, 1979. On June 27, 1985 AMBAC changed its name to WMBIC Indemnity Corporation (WMBIC), and on June 28, 1985 Verex Indemnity Corporation changed its name to AMBAC Indemnity Corporation.

Effective June 28, 1985, New AMBAC acquired the assets and assumed the liabilities of the municipal bond business of WMBIC. Pursuant to the order of the Commissioner, WMBIC entered into liquidation proceedings immediately following the transfer of business to New AMBAC.

Ambac Financial Group, Inc. (Ambac Financial), the former AMBAC, Inc., owns all of the common capital stock of Ambac Assurance Corporation, and was initially established in for the express purpose of acquiring and capitalizing an insurance company that would be successor to AMBAC. At the time of the formation of New AMBAC in 1985, the voting capital stock of AMBAC, Inc. was owned by the following participating investors:

Citibank, NA	86.9%
Management of WMBIC Indemnity Corporation	5.4%
Xerox Corporation	4.4%
Stephens, Inc.	<u>3.3%</u>
Total	100.0%

Subsequent to the formation of New AMBAC, Citibank, NA acquired all of the ownership interest of AMBAC Inc. On April 29, 1991, AMBAC Inc. was renamed Citicorp Financial Guaranty Holdings, Inc. (CFGH), and subsequently AMBAC Inc. was incorporated as a wholly owned subsidiary of CFGH. CFGH sold its equity interest in AMBAC Inc. through two public stock offerings, in which 50.3% of the capital stock of AMBAC, Inc. was sold in July of 1991 and the remaining 49.7% of the capital stock of AMBAC, Inc was sold in January of 1992. The common capital stock of Ambac Financial Group, Inc. is publicly traded on the New York Stock Exchange.

Effective July 11, 1997, the name of AMBAC Inc. was changed to Ambac Financial Group, Inc. the present name of the holding company parent, and the name of AMBAC Indemnity Corporation was changed to Ambac Assurance Corporation, the name presently used by the insurance company.

Ambac Assurance Corporation is the principal operating company in the Ambac Financial Group, and provides various operating functions and services on behalf of its affiliates pursuant to numerous intercompany relationships and agreements. Further discussion of the company's holding company organization, description of the significant affiliates of Ambac

Assurance, and description of intercompany transactions and agreements is included in the section of this report captioned "Affiliated Companies."

In 2002 Ambac Assurance wrote direct premium in the following states:

New York	\$143,358,954	23.8%
California	58,524,431	9.7%
Illinois	56,900,947	9.4%
Florida	27,167,257	4.6%
Massachusetts	26,996,450	4.5%
All others	<u>289,157,504</u>	<u>48.0%</u>
	<u>\$602,105,543</u>	<u>100%</u>

The company is licensed in all states, the District of Columbia, Guam and Puerto Rico. The company provides financial guaranty insurance on investment grade municipal finance and structured finance debt obligations. Financial insurance coverages written by the company generally guaranty timely payment when contractually due for principal and interest payments on underlying insured credit obligations.

Financial guaranty insurance functions as a form of credit enhancement that provides benefits both to debt issuers and to investors. Financial guaranty insurance can benefit an issuer by providing a higher credit rating on a credit obligation, enabling a debt security to be offered in financial markets at reduced interest costs and providing an issue with broader marketability. Insurance benefits for an investor can include protection from loss of principal and interest on debt security investments, enhanced marketability and market price stability for debt securities, and an increase in investor confidence based on the rigorous due diligence performed by financial guaranty insurers and securities rating agencies.

Ambac Assurance acquires business through credit issuers and their financial advisors or through investment bankers who are in contact with the company and who seek insurance. The company also obtains business through its active involvement in financial guaranty markets, and participates in competitive bidding with other insurers for prospective business. The company's insurance policies are not offered or sold through insurance agents, and its marketing operations do not employ a sales force of licensed insurance agents. The company uses countersignature agents in those states that require a resident agent to countersign policies, and has appointed agents for countersignature purposes.



The company's financial guaranty business is conducted in three primary markets: the U.S. public finance market; the U.S. structured finance and asset-backed securities market; and the international market. The U.S. public finance market includes taxable and tax-exempt bonds, notes, and other debt obligations issued by states, political subdivisions (including cities, counties, towns, and villages), water, sewer, and other utility districts, higher educational institutions, hospitals, transportation, housing authorities, and other jurisdictional authorities and agencies. Public finance obligations are typically supported by the taxing authority of the issuer or by the issuer's authority to realize a revenue stream through the levy of fees and assessments related to public sector services or facilities projects.

The U.S. structured finance and asset-backed securities market entails issuance of debt securities that are secured by a specific pool of financial or tangible assets. The underlying assets supporting the securities include pools of mortgage loans and home equity loans, pooled credit card receivables, trade receivables, and other forms of third-party financial obligations. Debt securities in the structured finance market include collateralized debt obligations supported by corporate or governmental debt, equipment enhanced trusts secured by specific tangible equipment assets, and asset-backed commercial paper transactions.

The international market is comprised of non-U.S. credit issuers including sovereign and sub-sovereign governmental authorities, utilities, structured and asset-backed obligation issuers, and other securities issuers that use financial guaranty products. The company has established a subsidiary in the United Kingdom that serves as a vehicle for company participation in the financial guaranty markets in the United Kingdom and in Western Europe. During 2000 the company entered into a business alliance with a Japanese insurer, and the company has initiated business entry into the Japanese financial guaranty markets.

The company is rated triple-A by the nationally recognized securities ratings agencies, and is one of five triple-A rated U.S. insurers that participate in the national and international financial guaranty insurance industry. The company's superior rating enables the company to be a significant competitive participant within the industry. The ratings provided by the ratings

agencies are based on comprehensive evaluation of the company's book of business and ongoing assessment of the company's capitalization and claims paying ability.

### **Soft Capital Facilities**

The company has established soft capital facilities which provide credit resources that the company could potentially call upon to access supplemental capital resources. The resources could provide additional capital in the event of significant adverse loss experience. Soft capital is not considered a part of statutory capital, but is considered by the rating agencies in assigning their rating of the company. To date the company has not exercised any of its rights to obtain funds through its soft capital facilities.

### **Credit Facilities**

Ambac Assurance and Ambac Financial maintain a revolving credit facility pursuant to a credit agreement with major US and international lending institutions. The current credit agreement, effective August 1, 2002, provides credit facility from six lenders up to an aggregate maximum loan commitment of \$300 million. The agreement provides for a loan commitment term of one-year duration from the agreement effective date, and provides for a loan maturity term of two-year duration in the event that funds are loaned under the agreement.

Pursuant to the credit agreement, each participating lender is obligated to lend advances of funds to Ambac Assurance and Ambac Financial up to an agreed maximum commitment from each respective lender. The Bank of Nova Scotia is a participating lender and is the Administrative Agent of the credit facility on behalf of all of the lenders. Potential borrowings under the credit facility are available for general corporate purposes including payment of claims.

### **Preferred Stock Put Options**

The company has transacted a series of perpetual put options for issuance of its own preferred stock. The counterparties to the put options are special-purpose master trusts and sub-trusts. Through the master trusts the company may potentially exercise put options to issue Ambac Assurance Corporation preferred stock to the sub-trusts at an agreed put option price. By issuing preferred stock under the option agreements the company at its discretion could access

new capital. If the put options were exercised, the company's preferred stock would confer the rights of an equity investor in the company. Under the put options the company could receive proceeds of up to \$800 million that would be available for any purpose including the payment of claims. Company management does not have any immediate concerns or plans that would give rise to issuance of preferred stock to obtain additional capital.

The following table is a summary of the net insurance premiums written by the company in 2001. The growth of the company is discussed in the Financial Data section of this report.

<b>Line of Business</b>	<b>Direct Premium</b>	<b>Reinsurance Assumed</b>	<b>Reinsurance Ceded</b>	<b>Net Premium</b>
New Issue/Secondary Market	\$385,782,612	\$ 667,068	\$46,087,343	\$340,362,337
Asset Backed Securities	200,059,353	91,584,184	49,196,274	242,447,263
Municipal Investment Contracts	3,740,743			3,740,743
Portfolio Insurance Products	1,186,168		196,039	990,129
Interest Rate Swaps	696,069			696,069
Structured Credit Derivatives	8,246,897			8,246,897
Affiliated--Investments	<u>2,393,699</u>	<u>0</u>	<u>0</u>	<u>2,393,699</u>
Total All Lines	<u>\$602,105,541</u>	<u>\$92,251,252</u>	<u>\$95,479,656</u>	<u>\$598,877,137</u>

New Issue insurance policies guarantee the timely payment of principal and interest when due on debt securities issued in the U.S. public finance market.

Secondary Market business entails issuance of guarantees on a subset of existing and here-to-fore uninsured debt issues. Insurance is issued on a portion of previously issued obligations that are in the secondary market, and is typically purchased by an institution (e.g., broker/dealer) to facilitate the sale of debt when an investor desires to have insurance on existing bonds that were not insured when first issued.

Asset Backed Securities insurance policies guarantee an obligor's performance under specific debt instruments backed by pools of mortgages, other assets, or payment streams from pools of receivables.

Municipal Investment Contract policies guarantee performance of municipal investment contracts issued by Ambac's affiliate, Ambac Capital Funding, Inc. The municipal investment contracts are used by bond issuers to temporarily invest bond issuance proceeds until the proceeds can be applied to finance their intended purpose.

Portfolio Insurance policies guarantee the payment of principal and interest on obligations held in a Unit Investment Trust or a Mutual Fund. The company previously guaranteed obligations held in individual portfolios, but this coverage was discontinued in 1984.

Interest Rate Swap policies guarantee the obligations of the company's affiliate Ambac Financial Services LP (AFSLP) to its counterparties in interest rate swap transactions. An interest rate swap is an agreement to exchange with a counterparty a stream of periodic payments calculated by reference to agreed upon interest rates, indices, and notional amounts. The insurance guarantees the contractual performance of AFSLP to the swap agreement counterparties.

Structured Credit Derivative policies guarantee the obligations of Ambac Credit Products, LLC (ACP), an affiliate, to its counterparties in structured credit derivative transactions. Under structured credit derivative transactions, ACP participates in structured default swaps for highly rated credit risks, and contracts to make payments to counterparties in the event of defined credit events that are related to an underlying credit obligation or a portfolio of obligations.

Affiliated-Investment policies guarantee the obligations of investment security assets that are purchased by Ambac Assurance affiliates. The policies are issued when an affiliate invests in a security that fails to meet the minimum internal investment quality criterion. As noted above, all obligations guaranteed by Ambac Assurance are investment grade.

### III. MANAGEMENT AND CONTROL

#### Board of Directors

The Ambac Assurance board of directors is comprised of seven members. The directors are elected annually by the company's sole shareholder, and each director is elected to serve a one-year term of office. Corporate officers are elected at the annual meeting of the board of directors. Members of the company's board of directors may also be members of other boards of directors in the holding company group. Directors who are not employees of Ambac Assurance Corporation are paid \$1,000 for each board meeting that they attend. Directors who are employees of Ambac Financial Group, Inc. or its affiliates are not paid compensation for their attendance at board meetings.

Currently the board of directors consists of the following persons:

<b>Name and Residence</b>	<b>Principal Occupation</b>	<b>Term Expires</b>
Phillip B. Lassiter New York, NY	Chairman and Chief Executive Officer Ambac Financial Group, Inc. and Ambac Assurance Corporation	2003
Michael Anthony Callen London, England	President, Avalon Argus Associates LLC (financial consulting)	2003
Renso Leo Caporali Clarence, NY	Retired Chairman and Chief Executive Officer of Grumman Corporation	2003
Jill M. Considine New York, NY	Chairman and Chief Executive Officer The Depository Trust & Clearing Corporation	2003
Richard Dulude Georges Mills, NH	Retired Vice Chairman Corning Incorporated	2003
Robert John Genader Westport, CT	President and Chief Operating Officer Ambac Financial Group, Inc. and Ambac Assurance Corporation	2003
William Grant Gregory Greenwich, CT	Chairman, Gregory and Hoenemeyer, Inc. (merchant banking)	2003

## Officers of the Company

The officers serving at the time of this examination are as follows:

Name	Office	2001 Compensation
Phillip B. Lassiter	Chairman and Chief Executive Officer	\$14,274,665
Robert J. Genader	President and Chief Operating Officer	8,429,612
Frank J. Bivona	Vice Chairman and Chief Financial Officer	780,000
David L. Boyle	Vice Chairman	780,000
Gregg L. Bienstock	Managing Director	611,579
Kevin J. Doyle	Managing Director, General Counsel	509,000

Annual compensation of the company's officers is paid by the holding company parent, Ambac Financial Group, Inc. The Group annually establishes an aggregate expense budget whereby a portion of various operating expenses including officer compensation is allocated and charged to various affiliated operating companies. A portion of the aggregate annual compensation of officers is allocated to Ambac Assurance through the Group's annual budgetary allocation process.

## Committees of the Board

The company's bylaws allow for the formation of an Executive Committee and other committees of the board of directors. At the time of the examination the company did not have any standing committees of its board of directors.

The board of directors of the company's holding company parent, Ambac Financial Group, Inc., has a standing audit committee that supervises a corporate-wide internal audit function. The audit committee reviews and evaluates internal audit issues and internal audit findings, and reports to the Ambac Financial Group, Inc. board of directors. The directors of Ambac Assurance attend and participate in the meetings of the board of directors of the parent company, are fully apprised of internal audit findings, and supervise internal control matters that pertain to Ambac Assurance Corporation.

#### IV. AFFILIATED COMPANIES

Ambac Assurance Corporation is a member of a holding company system. The organizational chart below depicts the relationships among the affiliates in the group. A brief description of the significant affiliates of the company follows the organizational chart.

##### **Ambac Financial Group, Inc. Organizational Chart**

Ambac Financial Group, Inc.	
Ambac Assurance Corporation	
Ambac Credit Products, LLC	
Ambac Credit Products Limited	
Ambac Assurance UK Limited	
Ambac Private Holdings, LLC	
Ambac Japan Co., Inc.	
Ambac Capital Services, LLC	
Connie Lee Holdings, Inc.	
Connie Lee Insurance Company	
Ambac Financial Services Holding, Inc.	
Ambac Financial Services, LP	(1)
Ambac Capital Corporation	
AME Holdings, LLC	(2)
AME Investments, LLC	
AME Asset Funding, LLC	
AE Global Holdings, LLC	(3)
AE Global Asset Funding, LLC	
AE Global Investments, LLC	
Ambac Securities, Inc.	
Cadre Financial Services, Inc.	
Ambac Capital Funding, Inc.	
Ambac Asset Funding Corporation	
Ambac Investments, Inc.	
Ambac All Corp.	
Ambac Conduit Funding, LLC	
Aleutian Investments, LLC	(4)
Juneau Investments, LLC	(4)

- (1) Joint venture ownership distribution: Ambac Assurance 90% and Ambac Financial Services Holding, Inc. 10%
- (2) Joint venture ownership distribution: Ambac Capital Corporation 45%, MBIA 45%, and Radian Reinsurance, Inc. 10%
- (3) Joint venture ownership distribution: Ambac Capital Corporation 50% and Radian Reinsurance, Inc. 50%
- (4) Joint venture ownership distribution: Ambac Assurance 1% and Ambac Conduit Funding, LLC 99%

##### **Ambac Financial Group, Inc. (Ambac Financial)**

Ambac Financial Group, Inc. was incorporated on April 29, 1991 in the State of Delaware, and is the parent holding company entity for the Ambac Financial group. Ambac Financial provides various administrative services to its subsidiaries, including credit surveillance

and risk management, legal services, regulatory compliance services, and investment management services. Subsidiaries of Ambac Financial provide financial guaranty insurance and other financial investment and service products to public and private finance business sectors.

As of December 31, 2001, Ambac Financial Group, Inc.'s audited GAAP basis financial statements reported total assets of \$12.3 billion, total liabilities of \$9.3 billion, and stockholders' equity of \$3 billion. Operations in 2001 provided reported net income of \$432.9 million.

#### **Ambac Credit Products, LLC (ACP)**

Ambac Credit Products, LLC is a limited liability corporation that is incorporated in the State of Delaware. ACP provides credit protection in the form of structured default swaps in the global financial markets. The swap contracts require that ACP make payments upon the occurrence of certain defined credit events related to underlying obligations. Should a defined credit event occur, ACP would generally make payment equivalent to the difference between the par value and the market value of the underlying obligation. ACP's swap agreements are issued to counterparties who seek to manage credit risk, and are structured to mitigate ACP's risk of loss and to reduce potential price volatility of the swap agreements. Structured credit derivatives issued by ACP are insured by Ambac Assurance.

As of December 31, 2001, Ambac Credit Products, LLC's unaudited GAAP basis financial statements reported total assets of \$101,139,106, total liabilities of \$96,380,111, and stockholders' equity of \$4,758,996. Operations in 2001 provided reported net income of \$2,822,076.

#### **Ambac Credit Products Limited (ACPL)**

Ambac Credit Products Limited is a limited liability corporation that is incorporated in the United Kingdom. ACPL provides credit protection in the form of structured default swaps in the European financial markets, similar to the business conducted by ACP in the US domestic markets. Structured credit derivatives issued by ACPL are insured by Ambac UK.



As of December 31, 2001, Ambac Credit Products Limited's unaudited financial statements reported total assets of \$14.8 million, total liabilities of \$7 million, and stockholders' funds-equity interests of \$7.8 million. Operations in 2001 provided reported net loss of \$11,000.

**Ambac Assurance UK Limited (Ambac UK)**

Ambac Assurance UK Limited was incorporated in the United Kingdom on September 11, 1996, and is authorized to transact credit, surety, and financial loss insurance business in the United Kingdom and 14 other European jurisdictions. Ninety percent of all Ambac UK liabilities on financial guaranty insurance policies issued are reinsured by Ambac Assurance. A stop-loss agreement requires Ambac Assurance to make payments if Ambac UK's incurred losses exceed £500,000 in any one-year period. Under a Net Worth Maintenance Agreement, Ambac Assurance agrees to ensure that Ambac UK has free assets of £10,500,000 as long as funding of Ambac UK net worth does not diminish the claims paying ability ratings of Ambac Assurance. Ambac Assurance also provides investment management and management services to Ambac UK.

As of December 31, 2001, Ambac UK's audited financial statements reported total assets of £95,376,000 (\$138,705,324), total liabilities of £82,112,000 (\$119,415,488), and total shareholder's funds-equity interests of £13,264,000 (\$19,289,836). Operations in 2001 provided reported net retained profit for the year of £475,000 (\$690,792). Ambac UK's financial statements were prepared in accordance with applicable United Kingdom law and accounting standards.

**Ambac Private Holdings, LLC (APH)**

Ambac Private Holdings, LLC is a limited liability corporation domiciled in Delaware. APH was established to invest in subordinate debt and in equity securities issued by enterprises for which Ambac Assurance has written financial guaranty insurance on senior debt obligations.

As of December 31, 2001, Ambac Private Holdings, LLC's unaudited GAAP basis financial statements reported total assets of \$81,250,035, total liabilities of \$63,719,569, and total stockholders equity of \$17,530,465. Operations in 2001 provided reported net loss before income taxes of \$5,376,289.

**Ambac Capital Services, LLC (ACSLLC)**

Ambac Capital Services, LLC is a limited liability corporation that was organized on March 5, 2002 as a Delaware corporation. ACSLLC is a wholly owned subsidiary of Ambac Assurance, and was established to write total return swaps.

**Connie Lee Holdings, Inc. (CL Holdings)**

Connie Lee Holdings, Inc. is a wholly owned non-operating subsidiary of Ambac Assurance Corporation, and serves as the intermediate holding company parent of Connie Lee Insurance Company. CL Holdings was originally incorporated on February 12, 1987 under the name College Construction Loan Insurance Association. CL Holdings was established by Congress as a private for-profit stock corporation in the District of Columbia, mandated to acquire and capitalize a wholly owned insurance company to provide financial guaranty insurance for credit securities issued by higher education institutions. Ownership of CL Holdings was acquired by Ambac Assurance effective December 18, 1997.

As of December 31, 2001, Connie Lee Holdings, Inc.'s unconsolidated GAAP basis financial statements (unaudited) reported total assets of \$132,811,719, total liabilities of \$2,443,059, and total stockholders equity of \$130,368,660. Operations in 2001 provided reported total income before taxes of \$1,453,112.

**Connie Lee Insurance Company (Connie Lee)**

Connie Lee Insurance Company is a Wisconsin domiciled insurer authorized to write surety and financial guaranty insurance business. Connie Lee discontinued writing new business in 1998, and its entire portfolio of risks for financial guaranty insurance business is in run-off. The business plan of Connie Lee is to maintain its present status as an inactive insurer and to run-off its remaining book of business.

Connie Lee was incorporated on January 11, 1968 as Sentry Indemnity Company, and was acquired by College Construction Loan Insurance Association (CCLIA) in 1987. CCLIA was established as a government-sponsored enterprise authorized by Congress under Title VII of the Higher Education Act, with a mandated mission of providing credit enhancement for higher education financings. Connie Lee operated from 1968 through 1997 as a financial guaranty

insurer for debt securities issued by colleges, universities, and similar institutions. Ownership of Connie Lee was acquired by Ambac Assurance effective December 18, 1997.

As of December 31, 2001, Connie Lee Insurance Company's audited statutory basis financial statements reported total admitted assets of \$189,408,144, total liabilities of \$77,342,272, and policyholder's surplus of \$112,065,872. Operations in 2001 provided reported net income of \$15,522,259.

**Ambac Financial Services Holdings, Inc. (AFSHI)**

Ambac Financial Services Holdings, Inc. was incorporated under the laws of Delaware on February 15, 1994. AFSHI serves as the sole general partner of Ambac Financial Services, LP, and owns a 10% interest in the partnership.

**Ambac Financial Services, LP (AFSLP)**

Ambac Financial Services, LP was established as a limited partnership under the laws of Delaware on April 6, 1994. AFSLP provides interest rate swaps and other derivative financial products to states, municipalities and their authorities, asset backed securities issuers, and other entities for which Ambac Assurance has written financial guaranty insurance on senior debt obligations. Interest rate swaps are used by credit issuers to manage interest rate risks in connection with their credit financing transactions. The obligations both of AFSLP and of its counterparties under the financial products issued by AFSLP are guaranteed by Ambac Assurance.

Ambac Assurance is the sole limited partner of AFSLP and owns a 90% interest in the partnership. Ambac Financial Services Holdings, Inc. is the sole general partner of AFSLP and holds a 10% interest in the partnership.

As of December 31, 2001, Ambac Financial Services, LP's audited GAAP basis consolidated financial statements reported total assets of \$277,475,105, total liabilities of \$195,979,868, and partner's capital of \$81,495,237. Operations in 2001 provided reported net income of \$17,619,241.

**Ambac Capital Corporation (ACC)**

Ambac Capital Corporation was incorporated under the laws of Delaware on September 16, 1994. ACC serves as the intermediate holding company parent of financial services operating subsidiaries, and provides investment management and administrative services to affiliates.

Separate company financial statements are not prepared for Ambac Capital Corporation. The investment agreements of the subsidiaries of ACC represent the majority of ACC's assets, liabilities, and net equity. As of December 31, 2001, the unaudited GAAP basis combined financial statements for the Ambac Investment Agreements reported total assets of \$5,407,267,672, total liabilities of \$5,313,263,564, and total stockholders' equity of \$94,004,108. Operations in 2001 provided reported net income of \$1,648,752.

**Ambac Securities, Inc.(ASI)**

Ambac Securities, Inc. is a registered investment broker dealer incorporated in the State of Delaware. On June 19, 1997 AMBAC Securities, Inc. (AMBAC ASI) acquired the assets of Cadre Securities, Inc. (Old Cadre Securities). Old Cadre Securities changed its name to CX, Inc. and AMBAC ASI changed its name to Cadre Securities, Inc (New Cadre Securities). Effective April 1, 2002, New Cadre Securities changed its name to Ambac Securities, Inc.

Ambac Securities Inc. serves as an investment broker for municipalities and school districts, for whom it buys and sells fixed income securities, mutual funds, and equity shares in local government investment pools.

As of December 31, 2001, Cadres Securities, Inc.'s audited GAAP basis financial statements reported total assets of \$2,643,784, total liabilities of \$1,295,813, and total stockholder's equity of \$1,347,971. Operations in 2001 provided reported net loss of \$403,912.

**Cadre Financial Services, Inc. (CFSI)**

Cadre Financial Services, Inc. is a registered investment advisor incorporated in the State of Delaware, and provides investment advisory services, administrative services, and managerial services. On December 31, 1996, AMBAC Investment Management, Inc. (AIMI) acquired the assets of Cadre Financial Services, Inc. (Old Cadre Financial). Old Cadre Financial

changed its name to CF Services, Inc. and AIMI changed its name to Cadre Financial Services, Inc.

As of December 31, 2001, Cadre Financial Services, Inc.'s audited GAAP basis financial statements reported total assets of \$23,793,212, total liabilities of \$1,374,677, and total stockholder's equity of \$22,418,535. Operations in 2001 provided reported net income of \$5,215,040.

**Ambac Capital Funding, Inc. (ACFI)**

Ambac Capital Funding, Inc. is a wholly owned finance subsidiary of Ambac Capital Corporation, and is incorporated in the State of Delaware. ACFI issues guaranteed investment agreements, including repurchase agreements, to financial guaranty insurance clients of Ambac Assurance. Investment agreements are issued to municipalities and to structured finance issuers, and are used by credit issuers to invest bond proceeds until the proceeds are needed for expenditures necessary for the intended purposes of the bonds. ACFI investment agreements provide for guaranteed payment of interest and invested principal, and are tailored to meet the expected cash flow requirements of bond issuers. ACFI investment agreements are insured by Ambac Assurance.

Separate company financial statements are not prepared for Ambac Capital Funding, Inc. Assets, liabilities, equity and income related to the business activity of ACFI are included in the valuation of the Ambac Investment Agreements, and are reflected in balances that are accounted for in Ambac Capital Corporation.

## Affiliated Agreements

1. Expense Sharing and Cost Allocation Agreement – Effective January 1, 1997, Ambac Assurance and certain of its subsidiaries and affiliates entered into an expense sharing and cost allocation agreement. Pursuant to the agreement, Ambac Assurance allocates a portion of its annual budget overhead expenses incurred to the participating subsidiaries and affiliates. Ambac Assurance also allocates to each respective subsidiary and affiliate the direct costs incurred by Ambac Assurance that are paid on behalf of the respective subsidiary and affiliate.
2. Expense Sharing Agreement – Effective June 1991, Ambac Financial Group, Inc. and Ambac Assurance Corporation established an expense sharing agreement that provides that each party will be reimbursed on a monthly basis for services that it has provided to or expenses that it incurred on behalf of the other party. All allocation of expense is to be calculated on the basis of GAAP. Services and costs allocated between the parties include employee costs, equipment, facilities, tax settlement expenses, employee benefit expenses, and legal and directors expenses.
3. Tax Sharing Agreement – Effective July 18, 1991, a tax sharing agreement was established between Ambac Financial Group, Inc. and its subsidiaries. Pursuant to the agreement, Ambac Financial annually files a consolidated federal income tax return on behalf of itself and its subsidiaries. For each taxable period, each subsidiary's portion of the consolidated federal income tax liability of the group is the respective subsidiary's separate tax. A subsidiary's separate tax is determined as the federal income tax liability that the subsidiary would have if the subsidiary filed its own separate federal income tax return.
4. Reinsurance Agreement – Ambac Assurance Corporation and Connie Lee Insurance Company entered into an excess of loss reinsurance agreement effective December 18, 1997 in connection with the Ambac Assurance acquisition of Connie Lee. The agreement provides that Ambac Assurance will accept as excess loss reinsurance 100% of the annual aggregate incurred loss of Connie Lee in excess of the contract attachment point.
5. Asset Management Agreement – Effective January 1, 1997, Ambac Assurance UK Limited appointed Ambac Assurance Corporation to provide investment advisory and management services. Pursuant to the agreement, Ambac Assurance has sole and exclusive authority to advise and invest without the prior consent of Ambac UK, and has full discretionary power and authority to act as Ambac UK's attorney-in-fact. The current agreement terminates as of December 31, 2004, and will automatically renew for successive three-year periods unless the agreement is non-renewed by either party pursuant to terms of the contract.
6. Management Services Agreement – Effective January 1, 1997, Ambac Assurance UK Limited appointed Ambac Assurance Corporation as management services provider, to provide such services and assistance as Ambac UK may request, including policy issuance and exposure systems development, data processing systems, computer services for data entry, computer operations and production, human resources, premium processing, payroll processing, cash management, budget, corporate reporting, accounts payable and receivable, financial services for control of general ledger accounting and administration of cash reconciliations, and investment accounting. Ambac Assurance allocates to Ambac UK its budgetary costs and its direct expenses incurred and paid on behalf of Ambac UK.
7. Net Worth Maintenance Agreement – Effective January 1, 1997, Ambac Assurance Corporation and Ambac Assurance UK Limited entered into a net worth maintenance agreement so that Ambac UK may maintain the highest possible claims paying ability rating from Standard and Poor's Corporation (S&P), FITCH Investors Services, Inc. (Fitch), and Moody's Investors Services, Inc. (Moody's). Ambac Assurance agreed that it will own, either directly or indirectly through a wholly owned subsidiary, 100% of the capital stock of Ambac

UK, and that it shall not create or cause to exist any lien on the capital stock of Ambac UK. The agreement provides that Ambac Assurance will cause Ambac UK to maintain Free Assets of £10.5 million or such greater amount as shall be required by United Kingdom law or regulatory authorities. Any contributions by Ambac Assurance for Ambac UK net worth maintenance shall in no way be required if it would have the effect of reducing Ambac Assurance Corporation's claims paying rating from S&P, Fitch, and Moody's. Free Assets means the amount of assets in excess of liabilities valued in accordance with the United Kingdom Insurance Companies Act of 1982.

## **V. REINSURANCE**

The company's reinsurance portfolio and strategy are described below. The company's reinsurance contracts contained proper insolvency provisions.

The company's assumption reinsurance program provides for the assumption of risks written by subsidiary insurers and for assumption of risks written on obligations issued in the international market. With regard to affiliated assumed business, the company assumes as quota share reinsurance a 90% portion of all policies of financial guaranty written by Ambac Assurance UK Limited. The company's assumption of Ambac UK direct risks is pursuant to a reinsurance treaty effective January 1, 1997. The treaty provides that the company will reimburse Ambac UK on a quota share basis for the aggregate of all incurred losses of Ambac UK on its net retention in any calendar year that exceed the attachment point of £500,000. The company also assumes an immaterial amount of risks on the run-off business of its inactive subsidiary Connie Lee Insurance Company.

The company assumes international business from MBIA Insurance Corporation (MBIA) under a reciprocal facultative reinsurance treaty that was effective June 1, 1995. From 1995 to 2000, Ambac Assurance and MBIA marketed international coverages under the unincorporated joint venture MBIA-AMBAC International (the "Joint Venture"). Under the Joint Venture, policies issued by each company were 50% reinsured by the other company. The Joint Venture terminated in March 2000, but the companies continue the reciprocal facultative reinsurance arrangements for their respective international business. The 1995 treaty covers financial guaranty business related solely to entities not located in the United States. Reinsurance liability is limited to the reinsurer's share of the gross amount payable for debt service obligations and includes the reinsurer's share of LAE paid by the issuing company.

The company cedes reinsurance to minimize losses from large risks, to diversify risk, to increase underwriting capacity for frequent bond issuers, to manage its portfolio of risks by bond type and geographic distribution, and to satisfy capital and surplus limitations. The company historically conducted its ceded reinsurance program through various treaty and facultative contracts with major reinsurers. Prior to April 2001 the company made quarterly bulk facultative



cessions of credits on which the company desired to mitigate its risk. Under the company's facultative contracts, Ambac Assurance submits business to its reinsurers as proposed ceded reinsurance, and the reinsurers are not obligated to automatically assume the company's proposed ceded business.

In 2001 the company established automatic surplus share ceded reinsurance treaties with six reinsurers that cover financial guaranty insurance issued by the company. The surplus share agreements provide that the company may automatically cede to the respective participating reinsurers a surplus share percentage of liability up to a maximum percentage specified for each respective reinsurer. With certain limitations, the company can automatically cede a minimum of 25% and up to a maximum of 75% of certain risks to the participating reinsurers. The surplus share treaty participating reinsurers and their 2002 respective maximum percentage participations are as follows:

<b>Reinsurer</b>	<b>Maximum Participation</b>
American Re-Insurance Company	30%
AXA Re Finance, Secursal Na Madeira	25%
Ace Guaranty Re Inc.	10%
Radian Reinsurance Inc.	15%
Ram Reinsurance Limited	10%
Sompo Japan Financial Guarantee Insurance Company	10%

## **VI. FINANCIAL DATA**

The following financial statements reflect the financial condition of the company as reported in the December 31, 2001, annual statement to the Commissioner of Insurance. Also included in this section are schedules that reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the company's Aggregate Risk Limit calculation for 2001. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Surplus per Examination."

**Ambac Assurance Corporation**  
**Assets**  
**As of December 31, 2001**

	<b>Assets</b>	<b>Nonadmitted Assets</b>	<b>Net Admitted Assets</b>
Bonds	\$4,780,455,542		\$4,780,455,542
Stocks:			
Common stocks	163,097,927	\$ 110,436	162,987,491
Cash	9,244,234		9,244,234
Short-term investments	176,539,067		176,539,067
Other invested assets	95,450,558	4,566,539	90,884,019
Receivable for securities	278,951		278,951
Write-ins for invested assets:			
Call options	1,878		1,878
Agents balances or uncollected premiums:			
Premiums and agents balances in course of collection:	650,578		650,578
Federal and foreign income tax recoverable and interest thereon	28,463,246	17,763,559	10,699,687
Electronic data processing equipment and software	873,860		873,860
Interest, dividends, and real estate income due and accrued	69,546,656		69,546,656
Receivable from parent, subsidiaries, and affiliates	930,543		930,543
Other assets nonadmitted:			
Furniture, equipment, and supplies	2,048,981	2,048,981	0
Leasehold improvements	7,722,222	7,722,222	0
Write-ins for nonadmitted assets:			
Other assets	<u>1,837,653</u>	<u>1,725,016</u>	<u>112,637</u>
Total Assets	<u>\$5,337,141,896</u>	<u>\$33,936,753</u>	<u>\$5,303,205,143</u>

**Ambac Assurance Corporation**  
**Liabilities, Surplus, and Other Funds**  
**As of December 31, 2001**

Losses	\$ 26,693,356
Loss adjustment expenses	150,000
Other expenses (excluding taxes, licenses, and fees)	55,499,520
Taxes, licenses, and fees (excluding federal and foreign income taxes)	8,124,629
Federal and foreign income taxes	123,406,561
Unearned premiums	1,808,296,533
Ceded reinsurance premiums payable (net of ceding commissions)	9,738,839
Amounts withheld or retained by company for account of others	567,770
Payable for securities	25,874,714
Write-ins for liabilities:	
Mandatory contingency reserve	1,243,678,649
Premiums in advance	<u>4,890,972</u>
Total Liabilities	3,306,921,543
Common capital stock	82,000,000
Gross paid in and contributed surplus	878,038,798
Unassigned funds (surplus)	<u>1,036,244,802</u>
Surplus as Regards Policyholders	<u>1,996,283,600</u>
Total Liabilities and Surplus	<u>\$5,303,205,143</u>

**Ambac Assurance Corporation**  
**Summary of Operations**  
**For the Year 2001**

**Underwriting Income**

Premiums earned	\$349,967,512
-----------------	---------------

Deductions:

Losses incurred	2,953,781
Loss expenses incurred	942,512
Other underwriting expenses incurred	72,310,226
Write-ins for underwriting deductions:	
Interest expense and bank fees	<u>4,613,216</u>
Total underwriting deductions	<u>80,819,735</u>

Net underwriting gain	269,147,777
-----------------------	-------------

**Investment Income**

Net investment income earned	261,130,413
Net realized capital gains	<u>3,015,843</u>
Net investment gain	264,146,256

**Other Income**

Write-ins for miscellaneous income:

Other miscellaneous income	<u>3,119,065</u>
Total other income	<u>3,119,065</u>

Net income before dividends to policyholders and before federal and foreign income taxes	536,413,098
Dividends to policyholders	<u>0</u>

Net income after dividends to policyholders but before federal and foreign income taxes	536,413,098
Federal and foreign income taxes incurred	<u>141,854,229</u>

Net Income	<u>\$394,558,869</u>
------------	----------------------

**Ambac Assurance Corporation**  
**Cash Flow**  
**As of December 31, 2001**

Premiums collected net of reinsurance	\$604,026,683	
Loss and loss adjustment expenses paid (net of salvage or subrogation)	1,041,941	
Underwriting expenses paid	59,150,110	
Other underwriting expenses	<u>4,107,182</u>	
Cash from underwriting		\$539,727,450
Investment income (net of investment expense)		246,522,612
Other income (expenses):		
Net amount withheld or retained for account of others	67,532	
Write-ins for miscellaneous items:		
Other miscellaneous income	3,119,065	
Other assets	<u>24,036</u>	
Total other income		3,210,633
Deduct:		
Federal income taxes paid		<u>47,500,000</u>
Net cash from operations		\$741,960,695
Proceeds from investments sold, matured, or repaid:		
Bonds	734,359,788	
Stocks	930,300	
Other invested assets	79,661,544	
Net gains or (losses) on cash and short-term investments	(958,036)	
Miscellaneous proceeds	<u>21,223,478</u>	
Total investment proceeds		835,217,074
Cost of investments acquired (long-term only):		
Bonds	1,665,830,590	
Stocks	9,996,040	
Miscellaneous applications	<u>30,726,275</u>	
Total investments acquired		<u>1,706,552,905</u>
Net cash from investments		(871,335,831)
Cash provided from financing and miscellaneous sources:		
Surplus notes, capital and surplus paid in	167,724,254	
Net transfers from affiliates	157,231	
Other cash provided	<u>874,651</u>	
Total		168,756,136
Cash applied for financing and miscellaneous uses:		
Dividends to stockholders paid	68,000,000	
Other applications	<u>138,643</u>	
Total		<u>68,138,643</u>
Net cash from financing and miscellaneous sources		<u>100,617,493</u>
Net change in cash and short-term investments		(28,757,643)
<b>Reconciliation</b>		
Cash and short-term investments, December 31, 2000		<u>214,540,944</u>
Cash and short-term investments, December 31, 2001		<u>\$185,783,301</u>

**Ambac Assurance Corporation**  
**Aggregate Risk Limits**  
**December 31, 2001**

Surplus to Policyholders as of December 31, 2001				\$1,996,283,600	
Contingency Reserve as of December 2001				<u>1,243,678,649</u>	
Total					\$3,239,962,249
Section					
A	Municipal Bond Insurance	\$353,939,014,905	0.33%	1,179,678,737	
B	Investment Grade Asset Backed Securities	86,820,311,650	0.67	578,744,197	
C	Collateralized Guaranties or Guaranties of Less than 7 Years Investment Grade Industrial Development Bonds	0	0.01	0	
	Other Investment Grade Obligations	410,036,613	1.00	4,100,366	
D	Other Investment Grade Obligations	2,856,102,436	1.50	42,841,537	
E	Noninvestment Grade Consumer Debt Obligations	0	2.00	0	
	Noninvestment Grade Asset Backed Securities	0	2.00	0	
	Guaranties on Noninvestment Grade Obligations Secured by				
F	First Mortgages on Commercial Real Estate and having a Loan to Value Ratio of less than 80%	0	2.50	0	
G	Other Noninvestment Grade Obligations	<u>0</u>	<u>4.00</u>	<u>0</u>	
		\$444,025,465,604			
Minimum Surplus to Policyholders and Contingency Reserve					<u>1,805,364,827</u>
Excess Surplus to Policyholders and Contingency Reserve as of December 31, 2001					<u>\$1,434,597,412</u>

This schedule calculates the company's minimum capital requirements, based on calculation of aggregate risk limitation pursuant to Article 69 of the New York Insurance Laws. A Wisconsin domiciled financial guaranty insurer is subject to Wisconsin minimum capital and surplus requirements pursuant to s. Ins. 3.08 and s. Ins. 51, Wis. Adm. Code. Ambac Assurance is also subject to the minimum capital requirements of the New York Insurance Laws, which are more restrictive than Wisconsin requirements for certain segments of financial guaranty business. The New York aggregate risk limitation requirement serves as an industry standard for the evaluation of minimum capital requirements of a financial guaranty insurer, and is used as the minimum standard in Wisconsin. The risk limitation calculation is based on an insurer's guaranteed principal and interest in force on various classes of insured credit obligations.

**Ambac Assurance Corporation**  
**Reconciliation and Analysis of Surplus**  
**For the Five-Year Period Ending December 31, 2001**

The following schedule is a reconciliation of total surplus during the period under examination as reported by the company in its filed annual statements:

	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
Surplus, beginning of year	\$899,022,700	\$1,006,829,273	\$1,162,638,538	\$1,503,303,247	\$1,655,151,035
Net income	198,614,567	271,807,969	262,756,260	381,327,661	394,558,869
Net unrealized capital gains or (losses)	9,110,377	16,961,208	33,134,370	(22,732,565)	26,944,931
Change in net unrealized foreign exchange capital gains (losses)				(1,234,624)	
Change in net deferred income tax					24,879,483
Change in non-admitted assets	(676,459)	(285,898)	(3,450,842)	104,216	(16,888,908)
Change in provision for reinsurance				(126,000)	126,000
Change in foreign exchange adjustment	(524,507)	793,142	(1,600,623)		
Cumulative effect of changes in accounting principles					(5,306,494)
Capital changes:					
Paid in	5,469,784	19,867,959			
Surplus adjustments:					
Paid in			210,500,855	8,483,815	167,724,254
Dividends to stockholders	(44,000,000)	(48,000,000)	(52,000,000)	(59,800,000)	(68,000,000)
Write-ins for gains and (losses) in surplus:					
Mandatory contingency reserve for adverse losses, net of tax	(60,187,190)	(105,335,115)	(108,675,311)	(154,174,715)	(183,269,124)
Exercise of stock options					363,554
Surplus, end of year	<u>\$1,006,829,273</u>	<u>\$1,162,638,538</u>	<u>\$1,503,303,247</u>	<u>\$1,655,151,035</u>	<u>\$1,996,283,600</u>

**Ambac Assurance Corporation**  
**Insurance Regulatory Information System**  
**For the Five-Year Period Ending December 31, 2001**

The following table is a summary of the company's NAIC Insurance Regulatory Information System (IRIS) analytic ratio results for the period under examination. The sole exceptional ratio that occurred during the period under examination is denoted with asterisks. An explanation of the exceptional ratio is provided following the table of IRIS ratio results.

	<b>Ratio</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
#1	Gross Premium to Surplus	28%	32%	30%	30%	35%
#2	Net Premium to Surplus	25%	28%	26%	25%	30%
#3	Change in Net Writings	20%	29%	18%	6%	46%**
#4	Surplus Aid to Surplus	5%	4%	3%	3%	4%
#5	Two-Year Overall Operating Ratio	0%	0%	0%	0%	0%
#6	Investment Yield	6.0%	6.0%	5.4%	6.9%	5.5%
#7	Change in Surplus	11%	14%	26%	10%	17%
#8	Liabilities to Liquid Assets	70%	69%	67%	67%	66%
#9	Agents' Balances to Surplus	0%	0%	0%	0%	0%
#10	One-Year Reserve Devel. to Surplus	0%	-1%	0%	1%	0%
#11	Two-Year Reserve Devel. to Surplus	-1%	-2%	-1%	1%	1%
#12	Estimated Current Reserve Def. To Surplus	1%	0%	0%	1%	0%



The sole exceptional IRIS ratio result of the company during the examination period was the 2001 exceptional value for ratio number 3, Change in Net Writings. The 2001 exception was due to a 43% increase in gross premiums written arising from strong business activity in the year. Reinsurance ceded increased by 19% in 2001, and net premium written increased by 45% during the year, resulting in an IRIS analytical net writings ratio in excess of the threshold for classification as an exceptional result. The company's annual gross par value written in 2001 increased by 17% to \$90.1 billion, the increase primarily due to a lower interest rate environment in 2001 that caused increased refinancing and new-money credit issuance activity.

**Growth of Ambac Assurance Corporation (000 omitted)**

<b>Year</b>	<b>Admitted Assets</b>	<b>Liabilities</b>	<b>Surplus As Regards Policyholders</b>	<b>Net Income</b>
1997	\$2,879,281	\$1,872,451	\$1,006,829	\$198,615
1998	3,289,594	2,126,956	1,162,639	271,808
1999	4,013,174	2,509,871	1,503,303	262,756
2000	4,388,185	2,733,034	1,655,151	381,328
2001	5,303,205	3,306,922	1,996,284	394,559

  

<b>Year</b>	<b>Gross Premium Written</b>	<b>Net Premium Written</b>	<b>Premium Earned</b>	<b>Loss And LAE Ratio</b>	<b>Expense Ratio</b>	<b>Combined Ratio</b>
1997	\$286,552	\$254,100	\$132,192	1.7%	20.8%	22.5%
1998	366,714	328,715	194,439	(7.2)%	18.4%	11.2%
1999	449,071	387,151	223,479	1.7%	16.2%	17.9%
2000	490,011	409,506	273,483	3.6%	16.5%	20.1%
2001	694,357	598,877	349,967	1.1%	12.3%	13.4%

The company was highly successful in the global economic environment and credit finance markets existent during the years under examination, and was able to expand its business activity and attain a high level of profitability. From 1996 to 2001, the company's annual earned premiums increased by 68%, to \$350 million at year-end 2001, and annual net income increased by 77%, to \$394.6 million. During the examination period total assets increased by 105%, total liabilities increased by 96%, and surplus increased by 123% to \$2 billion, reflecting the overall profitable investment and operating performance of the company and its subsidiaries during the five-year period.

**Reconciliation of Surplus per Examination**

The examination determined that there were no material misstatements of balance sheet accounts as reported by the company in its 2001 statutory financial statements, and did not make any reclassification of or adjustment to the year-end balances reported by the company. The examination determined that the company's surplus as regards policyholders as of December 31, 2001 was \$1,996,283,600.

## VII. SUMMARY OF EXAMINATION RESULTS

### Compliance with Prior Examination Report Recommendations

There were three specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Report of Executive Compensation—It is recommended that in the future, the company file a Report of Executive Compensation pursuant to the instructions of Form OCI 22-010.

Action—Compliance

2. Abandoned Property—It is recommended that the company comply with ch. 177, Wis. Adm. Code, and comparable laws in other states.

Action—Compliance

3. Schedule Y—It is recommended that all transfers be recognized and that the recognition be on a gross basis.

Action—Compliance

## **Summary of Current Examination Results**

### Conflict of Interest Disclosures

The Ambac Financial Group has a corporate-wide requirement that each officer, director, and employee annually affirm the Group's code of employee conduct, and requires that each individual complete and file an annual conflict of interest disclosure. The examiners note that company files indicate overall material compliance with the corporate policy.

Examination review of the disclosures made by the company's officers and directors found that the disclosures made by outside directors were not available for most of the years since the previous examination. In addition, the examiners were able to review disclosures made by company employees in 1998 but were unable to access for review the 1998 disclosures made by company officers and directors. It is recommended that the company ensure that its documentation of annual conflict of interest disclosures made by company officers and directors are retained from year-to-year so as to be available for review in subsequent periods, in compliance with the directive of the Commissioner.

### Financial Reporting of Contingency Reserve Change

The examination determined that historically the company reported its current-period changes in statutory contingency reserves as a direct write-in change to surplus. Section 3.08 of the Wisconsin Administrative Code requires that changes in contingency reserves be recorded in the income statement, whereas NAIC codification of statutory practice prescribes that change in contingency reserves be recorded as change to surplus. Accounting for contingency reserve change as change to surplus is the standard reporting practice used in the financial guaranty insurance industry.

The company's historical practice for reporting statutory contingency reserve change was not in compliance with Wisconsin regulatory requirements and had not been authorized by the Commissioner. The examiners informed the company that the company should either report change in contingency reserves as an income statement transaction, in compliance with s. Ins. 3.08(7)(b), Wis. Adm. Code, or otherwise obtain permission from the Commissioner to waive the Wisconsin statutory reporting requirement. Subsequent to completion of examination fieldwork,

the company obtained authorization of the Commissioner to continue reporting changes in contingency reserves as changes to unassigned surplus. The company is required to disclose in the notes to its statutory annual statements that the company reports contingency reserve change as change in surplus, in conformity with NAIC codification and as a Wisconsin permitted financial reporting practice, authorized and approved by the Commissioner.

#### Advance Premium Liability

As of year-end 2001, the company reported a \$4.9 million liability for "Premiums in Advance." Examination review determined that the reported liability included both advance premium liability and liability for premium receipts that had not yet been applied to respective policy records at year-end, and/or premium receipts that were not yet booked into company ledger accounts.

The NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions Property and Casualty define advance premium as premiums received in advance of the policy coverage period, and require that an appropriate liability be reported in the balance sheet under the caption "Advance Premium." The company's current reporting practice does not conform to NAIC standards, and incorrectly classifies reported premium liabilities. The examiners observe that the classification error was not material to the company's accounts, and the examination waived reclassification of premium liability balances. It is recommended that the company report any advance premium under the caption "Advance Premiums," and that the company classify and report premium receipts not yet applied to company accounts and records under an appropriate separate descriptive caption, such as "Suspense Premium Liability" or "Unapplied Premium Liability," in conformity with the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions Property and Casualty.

## **VIII. CONCLUSION**

Ambac Assurance Corporation is a financial guaranty insurer that is primarily engaged in insuring municipal and structured finance debt obligations. Insurance written by the company guarantees payment when due of principal and periodic interest on insured obligations in the event of credit default. The company is the successor corporation to American Municipal Bond Assurance Corporation, which was incorporated in 1970 and was the first municipal bond insurance company. Ambac Assurance is the primary operating company of Ambac Financial Group, Inc. The company and its affiliates provide investment products and services related to financial guaranty, credit derivative, and risk transfer business.

During the years under examination the company experienced significant business growth and increased profitability. Since the prior examination, annual net premiums written increased by 182% to \$599 million in 2001, and annual net income increased by 77% to \$395 million in 2001. During the period, total assets increased by 105% and total liabilities increased by 96%. Surplus increased by 123% during the period.

The examination determined that there were no material misstatements of account balances as reported by the company in its 2001 statutory financial statements, and did not make any adjustments or reclassifications of reported account balances. The examination determined that as of December 31, 2001 the company had total admitted assets of \$5,303,205,143, total liabilities of \$3,306,921,543, and policyholder's surplus of \$1,996,283,600.

## IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 34 - Conflict of Interest Disclosures—It is recommended that the company ensure that its documentation of annual conflict of interest disclosures made by company officers and directors are retained from year-to-year so as to be available for review in subsequent periods, in compliance with the directive of the Commissioner.
2. Page 35 Advance Premium Liability—It is recommended that the company report any advance premium under the caption “Advance Premiums,” and that the company classify and report premium receipts not yet applied to company accounts and records under an appropriate separate descriptive caption, such as “Suspense Premium Liability” or “Unapplied Premium Liability,” in conformity with the NAIC Accounting Practices and Procedures Manual and the NAIC Annual Statement Instructions Property and Casualty.

## **X. ACKNOWLEDGMENT**

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

<b>Name</b>	<b>Title</b>
Ryan Hanson	Insurance Examiner

Respectfully submitted,

Thomas E. Rust  
Examiner-in-Charge